

  <b>NATIONAL CONFERENCE of STATE LEGISLATURES</b>		<a href="#">Home</a> <a href="#">Press Room</a> <a href="#">Contact/Ask NCSL</a> <a href="#">Search</a> <a href="#">Site map</a>	<a href="#">Members Log-in</a>
<a href="#">NCSL Profile</a>	<a href="#">Policy Issues</a>	<a href="#">State Legislatures</a>	<a href="#">State-Federal Relations</a>
		<a href="#">Publications</a>	<a href="#">Meetings</a>

<a href="#">Login Here</a> <a href="#">Register Now</a>	To access <a href="#">special member content and services</a> , <b>legislators, legislative staff</b> and <b>Foundation for State Legislatures sponsors</b> must log in. ( <a href="#">Clear this notice.</a> )	<a href="#">NCSLnet Registration Help</a> <a href="#">Forgotten NCSLnet Password?</a>
--	---	--

## Foundation Fiscal Partners, Phase V

# The Appropriate Role of User Charges in State and Local Finance

Updated 29 July 1999

- [The Foundation Fiscal Partners](#)
- [Summary of Proposal](#)
- [Executive Summary](#)

---

## The Appropriate Role of User Charges in State and Local Finance: Contents

- [Introduction and Overview](#)
  - [Defining and Categorizing Taxes, Charges and Other Revenues](#)
  - [The Role of User Charges](#)
  - [The Role of Impact Fees](#)
  - [Trends in Reliance on Taxes, User Charges and Other Revenues](#)
  - [Principles for the Appropriate Use of User Charges in State and Local Finance](#)
  - [Suggestions for Further Reading](#)
- 

## Introduction and Overview

In 1997, the NCSL Foundation Fiscal Partners published a report about the growing use of local option taxes--taxes other than the property tax--as a revenue source for local governments ([1](#)). That report examined several reasons for the expansion of local option taxation in the 1980s and 1990s, including property tax limitations and the public acceptance of sales taxes. The report also noted that many states, including California, shifted from property taxes to user charges in the wake of property tax revolts.

The local option tax report also suggested another explanation for the growth of local option taxation--local governments that turned to user charges in the wake of the property tax revolt may now have maximized their use. This theory provoked questions from legislators and staff for more detail about the types of user charges and non-tax revenues that state and local governments were using to finance public services. They also questioned how reliance on such revenues has changed over time and what effect that has upon the stability, sufficiency and fairness of state and local revenue systems.

This report tries to address these questions. The first part provides an overview of changes in state and local revenue reliance and examines some explanations for recent trends. Next, it examines the effects of tax and expenditure limitations, public preferences, and other factors on the shifting state-local revenue mix. It also discusses the implications--for governments, taxpayers, and users of government services--of the shift away from broad-based taxes. Finally, it identifies seven policy principles that policymakers might use to examine their own states' reliance on user fees and charges and to use when considering changes in the tax and user fee mix. Detailed data tables are included as appendices to the report.

The report also discusses the role of development impact fees in financing infrastructure costs. Impact fees are one-time payments from property developers to governments for off-site infrastructure improvements necessitated by new development. Unlike traditional user fees, which generally fund current services, impact fees are used exclusively for capital improvements. The housing boom of the mid to late 1990s, combined with restraints on traditional local tax sources, has led many localities in high growth areas to expand the use of impact fees. Because impact fees have been at the forefront of many recent legislative debates, the NCSL Foundation Partners agreed that the report should include them in its scope.

---

## Defining and Categorizing Taxes, Charges and Other Revenues

In order to examine changes in state and local reliance on taxes, fees and other revenues, it is necessary to define these terms and identify the types of revenue sources they include. This sounds like an easy task, but in diverse state and local revenue systems, the distinction between taxes, user charges and other miscellaneous revenues can become blurred. Some revenue sources--like sales, income and property taxes, for example--clearly fall into the tax category. Park entrance fees, sewer charges, and highway tolls--payments for government services used--clearly fall into the user charge category. Lottery revenues, court-imposed fines, and sales of state property are neither taxes nor user charges for services, so they fall into the miscellaneous revenue category.

There are also numerous examples of revenue sources that are not so easily categorized. Impact fees on developers are much like user fees, but because they are used to finance infrastructure and not to pay for current government services, they are categorized not as user charges but as miscellaneous revenues. Some local governments charge telecommunications companies a user fee for the use of public rights-of-way. However, the charge frequently is collected as a percentage of gross receipts, a method that is virtually indistinguishable from a utility gross receipts tax. Other examples include special property assessments that are levied on the basis of property value (just like property taxes) for specific services like street lighting or fire protection.

These examples are used to highlight the difficulty of trying to neatly categorize where specific revenue sources fit into the tax, user charge, and other revenue categories. In fact, courts across the country are

asked to make these types of determinations every day, often with varying and contradictory results. In an attempt to bring consistency to these classifications, this report uses the tax, user fee, and miscellaneous revenue scheme developed and used by the U.S. Census Bureau's Governments Division (2). The Census Bureau has been collecting revenue data under this methodology for decades, and using the census methodology allows for the detailed time-series comparisons contained in the appendix of this report.

The terms "user charges," "fees," "current charges," and "user fees" are used interchangeably throughout this report and refer to the Census Bureau's "current charges" category described below. The Census Bureau classification manual defines taxes, current charges, and miscellaneous revenues as follows.

**Taxes** are compulsory contributions exacted by a government for public purposes, other than for employee and employer assessments and contributions to finance retirement and social insurance systems and for special assessments to pay for capital improvements. These include personal and corporate income taxes, franchise, gross receipts, sales and use, excise, property, and utility taxes. They do not include taxes to fund unemployment insurance, workers' compensation, worker or employer pension contributions, and Social Security and Medicare taxes.

**Current charges** are charges imposed for providing current services or for the sale of products in connection with general government activities, excluding utility service charges. This definition, because of its emphasis on current consumption of services, excludes impact fees that are used to fund capital projects. Current charges include tuition at state colleges and universities, tolls and transportation charges, parks and recreation fees, solid waste charges, and other fees for the use of government services.

**Miscellaneous general revenue** includes all other general revenue of governments from their own sources, including interest revenue necessary to pay the interest expenditure on private activity bonds. Examples include lottery revenue, funds from sales of state property, royalties from mining or timber activities on state lands, development impact fees, and interest earnings.

**General revenue from own sources** includes all government revenue except that classified as intergovernmental, liquor store, utility, or insurance trust revenue. It is the sum of taxes, current charges, and miscellaneous revenue described above. This category excludes federal aid.

The use of Census Bureau data allows for time-series comparisons because of the consistency of the bureau's classification methodology. It also helps avoid frequently inconsistent comparisons based upon state classifications of taxes, charges and other revenues.

## Legal Distinctions Between Taxes and User Charges

In some instances, there is very little practical difference between a tax and a fee. Legal distinctions between taxes and fees are very important, however, because many states have constitutional or statutory restrictions on the ability of local governments to levy taxes--restrictions that usually do not apply to fees. Also, tax limitations on state and local governments sometimes require extraordinary majorities or otherwise restrict taxes, but may not impose similar restrictions on fees.

The distinction is important because local governments are frequently given broad authority--either in statute or state constitution--to levy fees and charges as part of their regulatory authority (also termed "police powers"). Fees frequently are levied in association with zoning and land use decisions where local

governments are charged with enforcing requirements for adequate infrastructure, environmental protection and mitigation, and local building code enforcement. Local governments also may charge fees to cover their costs of building and maintaining public rights-of-way, frequently in connection with cable, telephone and electric utility corridors. Such fees and charges often do not require the express statutory authority of a state legislature. Also, these fees do not face the same level of due process, equal protection and other legal scrutiny as taxes.

Local government taxing authority, on the other hand, must be explicitly granted by the state legislature or authorized under the home rule provisions of the state constitution. In home rule states, localities may impose taxes unless explicitly prohibited from doing so by the constitution or by state statute.

For these reasons, courts in many states have tried to create a clear distinction between taxes and fees. This is a very difficult task, however, and the result has been a lack of consistency among the states about the legal distinction between taxes and fees. In general, state courts have examined the following issues when making their determinations.

### **Uses of the Funds**

Are revenues placed in the general fund or are they placed in a specific fund designed to cover regulatory or other costs? For example, some states impose fees on regulated industries that are intended to cover the cost of the regulatory agencies that oversee them. Courts generally have considered these to be fees if revenues are not used to fund other government activities. However, if these fees generate excess revenues for general government purposes, beyond what is necessary to cover regulatory costs, they frequently are considered taxes by the courts (3).

### **Source of the Fee or Tax Authority**

Is the authority to levy a fee or tax delegated to a regulatory authority or is it granted to the department of revenue? What is the legislative history and intent of the fee or tax legislation and which legislative committee authorized it--the tax committee or the committee with oversight authority over the agency? A fee that is imposed by the non-tax legislative committees and that is not part of the revenue section of the code may be less likely to be considered a tax.

### **Purpose and Intent of the Governing Body**

Is the purpose and intent of the fee or tax to raise revenues to benefit the community at large, or is it to meet the infrastructure and other needs of the fee or tax payer? This issue is particularly relevant in court cases that are considering whether fees charged on developers for new projects are taxes or regulatory impact fees. (The impact fee section of this report discusses several court cases in California related to this subject.)

---

## **The Role of User Charges**

User charges are charges imposed for providing current services or for the sale of products in connection with general government activities. Common examples include tuition at state colleges and universities,

athletic and other extracurricular activity fees at public elementary and secondary schools, highway tolls, public transportation charges, and parks and recreation charges. User charges are the equivalent of the operating portion of the state budget, not the capital portion of the budget. In other words, user charges pay for current consumption of goods and services and do not include fees for capital costs.

User charges have been a significant part of public finance for decades. State and local governments have imposed user fees for admission to parks and recreation facilities for decades. The first modern state turnpike--the Pennsylvania Turnpike--predated the creation of the federal interstate highway system. It opened in 1940, and it was financed by tolls.

## Pros and Cons

Proponents argue that user charges allow governments to impose the cost of services on the citizens who demand those services. This prevents general fund tax money from subsidizing government services where benefits accrue to specific individuals without benefit to the public at large. User fees, by assessing all or a portion of the cost of such services upon users, allow market forces to set an economically efficient level of services.

User fees may be particularly appropriate when state or local governments provide services that also are provided by the private sector, particularly if they are not core government services. Using general fund taxes to subsidize such services poses two problems. First, the benefit principle is violated if taxpayers statewide fund a service they do not receive. Second, subsidies allow the government provider to undercut the prices of private sector providers, leading to unfair competition. For example, a municipal health and fitness facility that is subsidized by general fund taxes may be able to offer lower rates than private facilities.

User charges also may be an effective method of reducing consumption of scarce resources. For example, many municipal water and sewer systems have switched from unmetered water service funded from general revenues to metered services where customers are charged based upon consumption. User fees provide strong incentives to conserve water, reduce wastewater discharge by industrial users, and reduce the volume of solid waste that requires landfill disposal.

State and local governments also impose user fees on businesses under the benefit principle--that is, firms that benefit from government services should pay for them. For example, some states impose user fees on regulated firms like electric utilities that cover the cost of the regulatory agency. Building permit fees imposed by some local governments are designed to cover the cost of building inspectors and personnel necessary to process permit applications.

User fees may not be appropriate to finance core government services, particularly social services and education programs where services and benefits are provided based upon social objectives like reducing poverty or providing equal educational opportunities. In fact, many state constitutions require states to provide an "equal" or "adequate" free education to all resident children. User fees for public education would contradict this constitutional principle.

Opponents of user charges argue that these fees may make state and local revenue systems more regressive--that is, low-income households may pay a greater proportion of their income for taxes and fees than do higher income households. Most state and local revenue systems already are regressive due to

their reliance on general sales, excise and property taxes (4). Shifting to user fee financing for services can make the system even more regressive, especially if low- and high-income households are subject to flat fees that ignore ability to pay. The problem is exacerbated at the local government level when shifting from property taxes to user fees because property taxes are only mildly regressive--higher home values (and property tax payments) typically are associated with higher income levels.

Another drawback of shifting from property tax or income tax funding of services to user charges is the lack of federal deductibility. User charges are not deductible, while state and local income and property taxes are deductible.

---

## The Role of Impact Fees

Impact fees are one-time payments from property developers to municipal, county, or school district governments for off-site improvements necessitated by new development. Fees may be based upon square footage, number of bedrooms, number of bathrooms, or other housing characteristics depending upon the use of the funds. These fees may be authorized by state enabling statutes or, in some states, may be imposed without legislative approval under the general home rule or regulatory authority granted by state constitutions and statutes. Impact fees differ from user charges as defined by the Census Bureau because they fund capital expenditures, not current consumption.

For decades, local governments have conditioned approval of proposed developments upon payment of fees for on-site utility and transportation improvements. They also have required "exactions" from developers--contributions of land from the parcel being developed for schools, parks or open space. However, impact fees are different because they involve cash payments to local governments for off-site improvements like schools, public safety, transportation, and parks and recreation facilities.

Impact fees are a relatively new phenomenon. The first state impact fee statute was adopted in Arizona in 1982, allowing municipalities to assess development fees to offset the costs of providing necessary public services to a development (5). The law required that "... the amount of any development fees assessed ... must bear a reasonable relationship to the burden imposed upon the municipality to provide additional necessary public services to the development" (*AZ Rev. Stat. Sec. 9-463.05*).

Many states followed Arizona's lead and adopted impact fee statutes in the 1980s and early 1990s. By 1991, 20 states had adopted impact fee authorizing legislation and, by the end of 1998, 29 states adopted such laws. Impact fees are most common in local and state legislative debates during times of housing booms, such as the late 1980s and the mid to late 1990s.

Impact fees have become an important local government revenue source in states like Arizona, California and Washington. These states have experienced rapid growth in residential housing development combined with strict revenue limitations that were adopted by voters during the property tax revolt that began in the late 1970s. Nationally, however, impact fees play a relatively small role in local public finance. Impact fees and other property-related assessments (other than property taxes) are just 0.3 percent of local revenues in 1996, down from 0.4 percent in 1977.



## Pros and Cons

Proponents of impact fees argue that impact fees require new development to pay its own way. Implicit in this argument is the belief that growth does not pay for itself, but instead imposes new service delivery costs on existing residents that are not fully recovered through future property taxes. Impact fee proponents also argue that the fees actually allow development to occur that local governing bodies and voters otherwise would not permit. They also argue that impact fees are an important growth management tool that allows localities, by setting fees at different levels, to steer growth to areas where infrastructure is underutilized and away from areas where infrastructure is inadequate to accommodate growth.

Proponents also argue that impact fees allow localities to use a "pay as you go" financing arrangement for new projects that avoids using general obligation debt. This improves the financial position of the locality and reduces the cost of borrowing for other capital needs. Finally, proponents argue that impact fees add certainty and specificity to the planning process because, unlike exactions negotiated with each individual project, impact fees are known in advance.

Opponents argue that impact fees subsidize existing residents by paying for improvements that benefit all property owners. In the case of schools, for example, education provides statewide benefits that do not accrue only to specific property owners in a development. Opponents also argue that impact fees provide a windfall gain to existing residents because by increasing the price of new homes they also increase the value of existing homes. Opponents also argue that impact fees make housing more expensive and put homeownership out of the reach of lower- and moderate-income households.

## Fee or Tax?

As noted in the previous section, the distinction between a tax and a fee has important legal consequences for governments and taxpayers. In general, courts have ruled that local taxing powers must be granted in state constitutions or by legislative authority. Fees, however, may be imposed without specific constitutional or statutory authority as part of the exercise of local regulatory (police) powers.

Several court cases from around the country provide a framework for determining whether certain kinds of local fees should be classified as taxes or fees. In addition, the U.S. Supreme Court has issued several rulings that apply to this question. In *Nollan vs. California Coastal Commission*, the U.S. Supreme Court ruled that impact fees must bear a reasonable relationship to the costs imposed by the development in order to qualify as legitimate regulatory fees.

Another U.S. Supreme Court Case from Oregon--*Dolan vs. City of Tigard*--imposed more strict guidelines on the use of impact fees. It required that impact fees be "roughly proportional" to development impacts (6). The Court said that impact fees must meet a three-part "rational nexus" test:

- The need for the proposed capital improvements;
- That the development's share of the project costs are proportional to its share of the fees paid; and
- That the projects funded with the fees will benefit the development.

To determine whether impact fees meet these tests, courts in many states have examined whether the fees were placed in the general fund or segregated in a special fund. Courts also have required localities to account thoroughly for the sources and uses of impact fee funds, again to ensure that the expenditures are

tied directly to the needs created by the development that is paying the impact fees.

## Who Bears the Burden of Impact Fees?

An important consideration in state and local debates about the imposition of impact fees is the incidence of such fees--that is, who ultimately pays them. It is possible for the burden of impact fees to be borne by the homebuyer (in the form of higher prices), the home builder (in the form of lower profits), the landowner (in the form of lower vacant land values), or some combination of the three.

Studies of one California county found that, in areas where there are high-priced houses, homebuyers absorbed most or all of the cost of impact fees in the form of higher home prices. In areas with less expensive homes, developers and landowners shouldered about three-quarters of the burden of impact fees and homebuyers paid the other one-quarter in the form of higher prices (7). The study also found that impact fees increased the value of existing homes.

## Impact Fees and Education

When it comes to impact fees, education appears to be a special and difficult case. Clearly, new development can impose staggering new costs on school districts, and school boards often have little or no control over the development decisions that drive these costs. Allowing school impact fees can help give school boards a voice in steering development to areas where school capacity is available.

On the other hand, education clearly has statewide benefits in terms of economic development, a qualified work force, an educated citizenry, and the increased earning power of educated citizens. In addition, state supreme courts (led by Arizona and Ohio) have begun to rule that the school capital construction component--not only the operating costs--are a matter of statewide concern. In Arizona, the court forced the legislature to take over the funding of school capital costs due to disparities in the ability of local districts to issue school construction bonds. Impact fees may cause additional disparities in the ability of local school districts to fund new schools; therefore, these fees could face new court and legislative scrutiny.

If supreme courts in other states follow the lead of Arizona (as they have done on operating state aid programs in numerous states), the use of impact fees as a local school revenue source could be called into question. The same disparities in bonding capacity among local districts would apply in the case of local districts' ability to raise funds through impact fees. Localities where development pressures are strong have significant leverage to levy impact fees, whereas localities that do not have significant growth pressures may generate very little revenue from impact fees.

State legislatures will want to consider the potential effect of such court decisions when determining the future role of impact fees in school construction financing.

### Impact Fees and Schools in California and Washington

Two states where impact fees play a major role in school capital construction are California and Washington. Both states are constrained by constitutional restrictions on property tax revenues.



In California, reliance on impact fees, exactions and special assessments increased dramatically in the 1980s as localities struggled to cope with property tax restrictions imposed by passage of Proposition 13 in 1978. Until 1986, only cities and counties could impose impact fees. However, the legislature broadened the authority to levy impact fees to school districts in 1986.

In the late 1980s and the early 1990s, California struggled under a severe regional recession, even as immigration swelled enrollment in public schools. Impact fees assumed a more important role in financing new school construction, and developers began to complain about the combined effect of city, county and school district impact fees on the cost of housing. A 1996 study found that impact fees added between \$20,000 and \$30,000 to a new house (5 percent to 19 percent of the purchase price) in one county in the San Francisco Bay area (8).

Local governments responded that, without such fees, growth could not occur at all. Because local property taxes are constrained and the state is unwilling or unable to assist with school construction costs, fees were said to be the only mechanism available to make services available to growing communities.

In 1998, the California Legislature voted to issue \$9.6 billion in state bonds to finance a backlog of K-12 school construction projects. As part of this package, new restrictions were imposed on the use of impact fees. School districts may use impact fees for only up to half of school construction costs, and only if they first try to pass a local bond issue and have at least 30 percent of their students on a year-round schedule. School districts that use impact fees also must limit costs to a per-pupil construction budget or else pay for additional expenditures from sources other than impact fees.

Washington's Growth Management Act of 1990 authorized cities and counties to collect impact fees on behalf of schools. School districts in high growth regions in Washington began to rely more heavily on impact fees during the 1990s because the main source of revenues for school construction--sales of timber from state-owned lands--declined due to logging restrictions and depletion of timber stands.

---

## **Trends in Reliance on Taxes, User Charges and Other Revenues**

State and local revenue systems have changed significantly during the past 25 years. State and local governments have reduced reliance on taxes--especially property taxes--and have increased reliance on user charges and miscellaneous revenues. This section discusses several factors that have contributed to this trend, including:

- The property tax revolt of the late 1970s and early 1980s and other restrictions on state and local taxation;
- Policymaker and voter acceptance of fees; and
- The effectiveness of fees in influencing behavior.

### **Tax Constraints**

State-imposed limits on property taxes have been a part of the state fiscal landscape for decades. A 1995 report by the Advisory Commission on Intergovernmental Relations found that 41 states had some type of limit on local property taxes, and reported that 36 of those 41 state limits were in place before 1978.

The nature of these limits changed dramatically in 1978, however, when California voters adopted Proposition 13, which rolled back property taxes to 1 percent of market value and limited annual increases in property values for tax purposes. In general, post-1978 limits were much more restrictive on local revenues than were earlier limits. Arizona, Massachusetts, New Mexico and Washington adopted very strict limits soon after passage of Proposition 13. In more recent years, Colorado, Missouri, Montana and Oregon have added strict limitations, as well.

Many states that do not fall under the "strict limitation" category require voter approval for mill levies that exceed a certain limit (9). Local governments in these states face a political constraint on property taxes that can be every bit as binding as legal constraints in other states. Fees become an attractive option for financing needed public services at the local level when property taxes are limited or when a property tax increase requires voter approval; fee increases do not.

The same dynamic may apply at the state level for states that require "supermajority" approval for tax hikes in state legislatures. Table 1 shows that 13 states now require a supermajority for tax increases, yet none of these states require more than a simple majority to pass a fee increase. The recent popularity of supermajority requirements--seven states have adopted them since 1992--may provide more impetus for legislatures to consider fee increases when states need additional revenue.

<b>Table 1. Supermajority Requirements and Other Constitutional Restrictions on Legislative Tax Powers</b>				
<b>State</b>	<b>Adopted</b>	<b>Referendum (R) or Voter Initiative (I)</b>	<b>Legislative Majority Required</b>	<b>Applies To</b>
<b>Arizona</b>	1992	I	2/3	All taxes
<b>Arkansas</b>	1934	R	3/4	All taxes except sales and alcohol
<b>California</b>	1979	I	2/3	All taxes
<b>Colorado</b>	1992	I	2/3	All taxes *
<b>Delaware</b>	1980	R	3/5	All taxes
<b>Florida</b>	1971	R	3/5	Corporate income tax **
<b>Louisiana</b>	1966	R	2/3	All taxes
<b>Michigan</b>	1994	R	3/5	State property tax
<b>Mississippi</b>	1970	R	3/5	All taxes
<b>Missouri</b>	1996	R	2/3	All taxes ***
<b>Nevada</b>	1996	I	2/3	All taxes

<b>Oklahoma</b>	1992	I	3/4	All taxes
<b>Oregon</b>	1996	R	3/5	All taxes
<b>South Dakota</b>	1978	I	2/3	Sales and income tax
	1996	R	2/3	All taxes
<b>Washington</b>	1993	I	2/3	All taxes ****

Notes:

\* Tax increases automatically sunset unless approved by the voters in the next election.

\*\* The constitution limits the corporate income tax rate to 5 percent; a 3/5 vote is needed to increase it beyond 5 percent.

\*\*\* The constitution requires voter approval for significant tax increases. In emergencies, the legislature can increase taxes with a 2/3 vote.

\*\*\*\* Tax increases that produce revenues that do not exceed the spending limit must be approved by a 2/3 legislative vote; tax increases that produce revenue over the limit must be approved by a 2/3 legislative majority and by the voters.

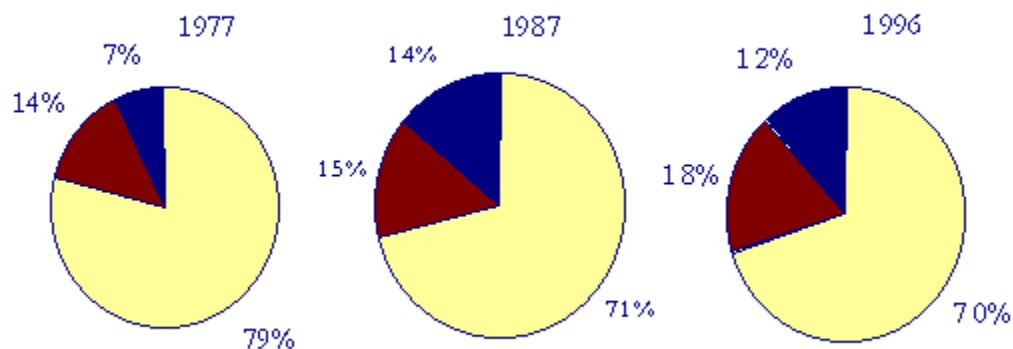
Source: NCSL, 1998.

In addition to legal constraints on state and local taxes, fees also appear to have gained in political popularity with both state and local lawmakers and voters. Some taxpayers perceive taxes as compulsory payments for services from which they do not necessarily benefit. Fees, on the other hand, are perceived as payments for services received by the payer. Although the reality may not always be clear-cut, perceptions frequently guide public policy, and fees do not seem to have the political stigma of taxes.

## Trends in User Charges

Appendices A, B, and C provide detailed comparisons of the relative changes in user charges and other miscellaneous state and local revenues during the past 20 years. Over the last twenty years, state and local governments reduced reliance on taxes to fund government programs and services. As figure 1 shows, the tax share of own-source state and local revenues fell from 79 percent in 1977 to 70 percent in 1996. State by state percentage breakdowns are shown in Appendix B.

**Figure 1. Composition of State-Local Own-Source Revenue**



The data show that both user charges and miscellaneous revenues have increased to fill this gap, with the user charge share increasing by 4 percentage points and the miscellaneous revenues share increasing by 5 percentage points.

Table 2 shows that, in relation to personal income, property taxes have fallen significantly between 1977 and 1996. Income and sales taxes have increased slightly, while excise and other miscellaneous taxes have fallen. These reductions in taxes have been more than offset by the growth in charges and other miscellaneous non-tax revenues.

<b>Table 2. State and Local Revenues per \$1,000 of Personal Income</b>			
	<b>1977</b>	<b>1987</b>	<b>1996</b>
<b>Total Own Source Revenue</b>	<b>\$153.45</b>	<b>\$157.34</b>	<b>\$162.01</b>
<b>Taxes</b>	<b>\$121.22</b>	<b>\$111.35</b>	<b>\$112.99</b>
Property	41.58	33.98	34.34
Sales	25.96	26.88	27.72
Personal and Corporation Income	27.49	28.68	29.33
Other	26.19	21.84	21.60
<b>Charges</b>	<b>21.48</b>	<b>24.05</b>	<b>29.88</b>
Miscellaneous General Revenue	10.75	21.94	19.14

User charges fall into four major categories: education, transportation, environment and natural resources,

and other. Appendix table B8 shows that education charges are the single largest category, providing about 27 percent of all state and local charge revenue. Environment and natural resource charges are next with about 20 percent, followed by transportation with 9 percent. The "other" category represents about 43 percent.

Between 1977 and 1996, education's share of user charge revenues fell from 33 percent to 27 percent of user charge revenue. This reduction in the relative share of education charges reflects two trends. First, K-12 education charges as a share of personal income fell by 25 percent, and second, even though higher education charges increased in real terms by more than 30 percent, growth in other user charges reduced the relative share of user charge revenue from education.

User charges in the environment and natural resource areas showed the largest increase in relative share of user charge revenues, increasing from 14 percent to 20 percent between 1977 and 1996. Most of the growth came in two areas: local sewage charges and local solid waste charges. Two factors were largely responsible for the growth in charges in these areas. First, to provide incentives for waste reduction and conservation, some local governments shifted financing for these activities from property taxes to user charges. Second, constraints on landfill space and tougher Clean Water Act standards increased the cost of disposal so fees were increased.

States and localities reduced their reliance on transportation charges during the last 20 years. Declines in reliance on highway tolls and other transportation user charges were offset somewhat by increases in air transportation fees. Air transportation charge increases reflect increased landing fees imposed on commercial aircraft and a federal law adopted in 1990 that allows government-owned airports to levy "passenger facility charges" on airline tickets. Not surprisingly, cities in states with major airline hubs showed significant increases in air transportation fee revenues during the period.

## **Trends in Other Miscellaneous Revenues**

Miscellaneous state and local government revenue as a share of total revenue also grew during the last 20 years, from 7 percent in 1977 to more than 12 percent in 1996. Interest revenue is by far the largest component of the miscellaneous category, providing nearly half of all such revenue in 1996. The interest share increased from 43 percent in 1977 to 49 percent in 1996. Interest revenue includes interest on deposits and accounts of state general and trust funds (excluding retirement, unemployment, and workers' compensation trust funds) and interest on bonds issued held for capital projects.

Interest revenues come from several sources. Alaska and several other western states have large, interest-earning trust funds that were established with revenues from mining and mineral companies. Alaska's "permanent fund" generated nearly \$3,500 per capita in interest and dividend earnings in 1996.

The relative share of interest earnings also has increased due to improved money management practices by state and local government treasurers. At the end of 1996, for example, states carried more than \$20 billion in rainy day funds and unobligated balances (10). Many local governments also carried cash balances. These large balances allowed governments to generate significant interest earnings.

Another growth area in the miscellaneous category is net lottery revenue. The number of states with lotteries increased dramatically between 1977 and 1996, from 13 to 38. As a result, net lottery revenue as a share of personal income quadrupled, and lottery revenues as a share of miscellaneous revenues jumped

from 5.4 percent to 11.7 percent. Still, lottery revenues represent only 1.3 percent of total own-source state revenues.

Other miscellaneous revenue sources declined in relative importance between 1977 and 1996. Real estate impact fees and special assessments fell from 5.6 percent to 2.7 percent, while the share from court-imposed fine and forfeiture income fell from 4 percent in 1977 to 3 percent in 1996. In real terms, both revenue sources grew. However, that growth was overshadowed by the much larger interest and lottery revenue growth.

---

## **Principles for the Appropriate Use of User Charges in State and Local Finance**

Principles one through five address user charges and principles six and seven relate to property-related assessments and impact fees. Each principle is discussed in greater detail below.

1. User charges may be appropriate when government is performing a service that narrowly benefits an individual taxpayer, or for certain government activities that compete directly with private sector providers.
2. User charges may be appropriate to provide market-based incentives to encourage or discourage the use of public resources.
3. Policymakers need to consider the impact on low- and moderate- income citizens of shifting reliance from broad-based taxes to user fees.
4. User charges may not be appropriate to fund services when states have a constitutional or statutory obligation to provide those services to all citizens.
5. User charges should cover the cost of the services provided. They should not be used to generate excess revenues that are diverted to unrelated programs or services.
6. Property-related assessments and impact fees may be appropriate to finance services tied to new development, but should not be used to subsidize new services for existing residents. In states where impact fees are deemed appropriate, state legislatures should adopt enabling legislation that governs the imposition of such charges.
7. Policymakers should be mindful of how property-related assessments and impact fees for new school construction are integrated within the state and local school construction program.

### **1. User charges may be appropriate when government is performing a service that narrowly benefits an individual taxpayer, or for certain government activities that compete directly with private sector providers.**

Many state and local government services provide important benefits to society as a whole. In fact, one of the most important reasons government exists is to undertake tasks that the private sector is unwilling or unable to because such tasks are unprofitable or because the financial benefits accrue to society as a whole and not to an individual firm.

However, some government services provide benefits directly to individual taxpayers instead of the public



at large. A sewer connection charge that reflects the direct cost of labor and materials to connect a new home to a municipal system is one example. Another is a building permit fee that covers the cost of a city building inspector. In both instances, the benefits accrue directly to the owner of the property.

In other instances, governments provide services for individual taxpayers that compete directly with private sector providers. Some examples include health and fitness facilities and the leasing or rental of government property. It is appropriate for governments to charge users for the full cost of providing such services. Subsidizing such services with general government tax revenues may give government service providers an inappropriate price advantage over the private sector. Although such competition may reduce prices for consumers, true competition requires that the government's full cost of providing the service be reflected in the prices charged to users.

Some services, like mass transit, may fall into gray areas between private and public benefits. Most policymakers agree that users of public transportation should be charged for the service. However, gasoline taxes and other revenues sometimes are used to subsidize public transit because public transportation also provides certain benefits--such as reduced congestion on freeways and less air pollution--to non-users. In such instances, a combination of charges and taxes may be appropriate.

## **2. User charges may be appropriate to provide market-based incentives to encourage or discourage the use of public resources.**

One of the contributing factors in the increase in state and local reliance on user charges is the recognition that charges can provide incentives to change behavior. User charges can be an effective tool to encourage wise use of natural resources. Some economists argue that the use of these "market-based" incentives is more cost effective than the traditional regulatory approach.

There are many examples in the field of environmental protections. Environmental permitting charges based upon the volume and toxicity of emissions can provide incentives to reduce emissions. Volume-based fees for water usage or solid waste disposal may encourage recycling and process changes that reduce solid waste volume. Some states also have tried congestion-based pricing for toll highways to encourage motorists to use highways during off-peak hours. In the 1990 rewrite of the Clean Air Act, Congress introduced a system of tradable emissions credits in order to provide market-based incentives for power plants to reduce emissions in the most cost effective manner possible.

User charges can serve the dual role of providing incentives to minimize pollution while funding the costs of regulatory agencies. However, some state agencies that rely on user charges to fund their operations may be concerned that volume-based charges will be too successful in reducing emissions, and thus also will reduce their operating revenues. Policymakers will want to be careful that this concern does not limit the willingness of agencies to use or expand fee programs.

## **3. Policymakers need to consider the effects on low- and moderate-income citizens of shifting reliance from broad-based taxes to user fees.**

User fees are just one component of the overall revenue system that finances state and local governments. In *Principles of a High Quality State Revenue System*, the NCSL Fiscal Partners made a strong case that policymakers should consider the revenue system as a whole and not just its individual parts. In this

context, policymakers need to be mindful of how changes in reliance on user charges will affect the entire revenue system and the impacts of such changes on low- and moderate-income households.

Replacing taxes with user charges will have different effects on taxpayers at different income levels, depending upon the type of service and the type of tax that previously funded that service. Property taxes are considered by most economists to be regressive--that is, low-income households pay a larger share of their income in property taxes than high-income households. However, property taxes are not as regressive as most state and local sales and excise taxes and they may be less regressive than some types of user fees.

For example, shifting the financing of trash collection from the municipal general fund (financed by property taxes) to a user charge may shift more of the cost to low- and moderate-income households. This is because wealthier families tend to live in more expensive houses and pay more in property taxes, so they contribute a proportionally larger share of general fund services. Under a user fee system, both lower income and higher income households would pay the same trash collection fees.

Shifting from general fund taxes to user fees will not always impose more costs on lower income households. If the shift from general taxes to user fees will fund a service that lower income households tend not to use as much as wealthier families, the shift to user fees could benefit lower income households.

Another implication of the replacement of property or income taxes with user fees is the loss of federal income tax deductibility. Income and property taxes are deductible from the federal income tax, while user charges are not. If user charges replace income or property taxes, taxpayers who itemize will pay more in federal taxes.

#### **4. User charges may not be appropriate to fund services when states have a constitutional or statutory obligation to provide those services to all citizens.**

Some state statutes and constitutions declare that certain services must be provided to all citizens without regard for their ability to pay. These decisions usually are tied to an important statewide benefit or goal. For example, most state constitutions--either explicitly or through state Supreme Court interpretations--declare that a fundamental role of the state is to provide a free public education. Originally, this duty was rooted in the belief that an educated citizenry was fundamental to a democratic society. More recently, states have also recognized that education has important statewide economic benefits that go beyond the economic benefit to the individual--to attract and retain industry and improve business and individual tax collections.

#### **5. User charges should cover the cost of the services provided. They should not be used to generate excess revenues that are diverted to unrelated programs or services.**

User charges should be designed to require the beneficiaries of a specific service to pay for it. When user charges are set above the cost of service, either to generate excess revenue for general government expenditures or for other earmarked uses, payers of user charges are unfairly overcharged for services.

Governments need to make a careful accounting for the costs of services and the user charge revenues raised to fund the service. If user charges exceed the cost of providing services, or if separate accounting is not used, governments are vulnerable to court rulings that such charges are taxes. Taxes are subject to much stricter court scrutiny and, in the case of local governments, may require explicit state legislative authorization. Also, a court ruling that a fee is really a tax may subject it to voter approval or supermajority requirements imposed on tax increases in some states.

## **6. Property-related assessments and impact fees may be appropriate to finance services tied to new development, but should not be used to subsidize new services for existing residents. In states where impact fees are deemed appropriate, state legislatures should adopt enabling legislation that governs the imposition of such charges.**

Rapid growth in some major metropolitan areas has overwhelmed available infrastructure for transportation, education and natural resources. Impact fees and special property assessments have become more prevalent as a means of funding infrastructure development, raising issues of inequities between current and new residents and effects on housing affordability.

Impact fees, applied appropriately, enable growth to occur in areas where existing residents are unwilling or unable to pay for new infrastructure costs. They require developers to include the full cost of a project's infrastructure needs in calculations of the cost of a proposed project.

Impact fees also provide local governments with a tool to steer development to areas where infrastructure can accommodate additional growth. Impact fees may be lower or nonexistent in areas where existing infrastructure can accommodate new development. These market-based incentives may be an appropriate use of charges (Principle 2).

Impact fees are not appropriate for upgrading the neglected infrastructure needs of current residents by forcing the costs onto new residents. Neither should they be used to generate additional general fund revenues for local governments.

In states that have not adopted impact fee enabling legislation, the courts are required to decide appropriate rules governing impact fees. These decisions are more appropriately decided in state legislatures, where elected policymakers can weigh the statewide and local interests of all interested parties and set uniform policies for the state.

## **7. Policymakers should be mindful of how property-related assessments and impact fees for new school construction are integrated within the state and local school construction programs.**

In the 1980s, state courts began to play an active role in forcing state legislatures to rewrite school finance formulas to ensure that school districts in poor areas had adequate resources to provide a quality education for their residents. As the 1990s draw to a close, some state courts now are looking beyond school operating expenses and considering whether state and local school construction programs provide adequate resources to poorer areas.

School districts in high growth states have increased their reliance on impact fees to finance new schools. However, much as local property tax resources vary between wealthy and poor regions of states, there are disparities in how much impact fee revenue is available to finance school construction in high-growth and low-growth regions of a state. To the extent that local governments rely on impact fees to fund schools, these impact fees may face additional court scrutiny.

State policymakers should examine how impact fees fit into the overall program for building, equipping and maintaining schools. Legislatures need to consider whether statewide guidelines for the use of impact fees for schools should be established to ensure that such fees do not create disparities that invite court action.

---

## Suggestions for Further Reading

Dresch, Marla, and Steven M. Sheffrin. *Who Pays for Development Fees and Exactions?* San Francisco: Public Policy Institute of California, 1997.

Freilich, Robert H., and David W. Bushek, eds. *Exactions, Impact Fees and Dedications: Shaping Land Use Decisions and Funding Infrastructure in the Dolan Era*. Chicago: American Bar Association, 1995.

*Impact Fees and the Role of the State: Guidance for Drafting Legislation*. Upper Marlboro, Md.: National Association of Home Builders, 1993.

Mackey, Scott. *Critical Issues in State-Local Fiscal Policy: A Guide to Local Option Taxes*. Denver, Colo.: National Conference of State Legislatures, 1997.

Foundation for State Legislatures and the National Conference of State Legislatures. *Principles of a High Quality Revenue System: Second Edition*. Denver, Colo.: National Conference of State Legislatures, 1991.

Price, Glenn A. Jr., Paul B. Whitty and Andrew M. Fleischman. "Financing Capital Improvements through Impact Fees: An Option for Local Governments in Kentucky?" *State Tax Notes*, 14, no. 14, April 6, 1998.

*Rethinking School Impact Fees*. Olympia, Wash.: Washington Research Council, 1995.

Salkin, Patricia E. *Impact Fees for New York Municipalities: Time for Legislative Action?* Albany, N.Y.; Albany Law School, 1991.

*U.S. Bureau of the Census Classification Manual*. Washington, D.C.: Government Printing Office, 1992.

---

## Footnotes

1. Scott Mackey, *Critical Issues in State-Local Fiscal Policy: A Guide to Local Option Taxes*. (Denver, Colo.: National Conference of State Legislatures, 1997). [[back](#)]
2. *U.S. Census Bureau Classification Manual*, p. 7-1 et seq. [[back](#)]
3. Glenn A. Price Jr., Paul B. Whitty and Andrew Fleischman, "Financing Capital Improvements Through Impact Fees: An Option for Local Governments in Kentucky?" *State Tax Notes*, 14, no. 14, April 6, 1998, p. 1115. [[back](#)]
4. Michael P. Ettlinger et al., *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* (Washington, DC: Citizens for Tax Justice, 1996), p. 2. [[back](#)]
5. Patricia E. Salking, *Impact Fees for New York Municipalities: Time for Legislative Action?* (Albany, N.Y.: Albany Law School, 1991 ), p. 167. [[back](#)]
6. Larry B. Morandi et. al., *Rural Growth in Western States: Economic Development and Environmental Protection* (Denver, Colo.: National Conference of State Legislatures, 1995), pp. 18-20. [[back](#)]
7. Marla Dresch and Steven M. Sheffrin, *Who Pays for Development Fees and Exactions?* (San Francisco: Public Policy Institute of California, 1997), pp. 64-68. [[back](#)]
8. Ibid., p. 3.[[back](#)]
9. *Tax and Expenditure Limits on Local Governments* (Washington, D.C.: Advisory Commission on Intergovernmental Relations, 1995), pp. 16-25. [[back](#)]
10. Corina Eckl and Arturo Perez, *State Budget Actions 1996*. (Denver, Colo.: National Conference of State Legislatures, 1996), p. 8. [[back](#)]

---

Call the **Marketing** Department in Denver at 303-856-1621 to order this publication, which includes 61 data tables in its appendices.

---

Reviewed December 2003

Email [statetax-info@ncsl.org](mailto:statetax-info@ncsl.org) for more information.

[Visitor counts for this page.](#)

---

**National Conference of State Legislatures**  
[INFO@NCSL.ORG](mailto:INFO@NCSL.ORG) (autoresponse directory)

Denver Office ([Map](#)):  
7700 East First Place  
Denver, CO 80230  
Tel: 303-364-7700  
Fax: 303-364-7800

Washington Office:  
444 North Capitol Street, N.W., Suite 515  
Washington, D.C. 20001  
Tel: 202-624-5400  
Fax: 202-737-1069